

**Internal Revenue Service**

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Date 12/17/96

Surname [REDACTED] *W*

Department of the Treasury

Washington, DC 20224

Person to Contact: [REDACTED]

Telephone Number: [REDACTED]

Refer Reply to: CP:E:EO:T:1:LMB

Date: SEP 25 1996

Employer Identification Number: [REDACTED]  
Key District: Ohio (Cincinnati)

Dear Applicant:

We have considered your application for recognition of exemption from federal income tax under section 501(a) of the Internal Revenue Code as an organization described in section 501(c)(4). Based on the information submitted, we have concluded that you do not qualify for exemption under that section. The basis for our conclusion is set forth below.

FACTS

You were incorporated on [REDACTED] as a non-profit corporation under the laws of [REDACTED]. According to your Articles of Incorporation, your purposes are to conduct and support activities that are for the benefit of, to perform the functions of, or to carry out the purpose of, [REDACTED] ("[REDACTED]"), principally its health plans, its health care facilities, and its College of Medicine, in support of the educational and health care responsibilities granted to the University by law. The members of your organization are comprised of your Board of Directors, all of whom must be officials of [REDACTED].

Your primary activities are the performance of managed care services, which include utilization review, case management and precertification, to your contract holders and their participants on a capitation basis. Through agreements with various third party administrators, you make available health care services to the faculty and staff of [REDACTED], to other hospitals in [REDACTED] and to other self-insured groups. You operate a network of contract providers, primarily the specialty physicians at [REDACTED] and the community physicians serving the primary care needs of the communities you serve.

In essence, you are engaged in two related activities. You operate and manage a health care provider network that enables employees of contract holders located in various communities in [REDACTED] to obtain better access to health care and better quality of

[REDACTED]

health care services. In addition, you provide these contract holders with various types of network management services.

Your principal contract holder is [REDACTED], which provides [REDACTED]'s employees and their dependents (approximately [REDACTED] covered lives) access to your health care provider network. You also provide [REDACTED] with various network management services. A number of small employers (those with less than 100 employees) and large employers (those with 100 or more employees) also have access to your network.

Approximately [REDACTED] [REDACTED] students ([REDACTED] covered lives) purchase indemnity health coverage under a program that is underwritten by an independent insurance company. While you do not administer this program, subscribers to this program do have access to your network and discount arrangements. Currently, you are developing a program to provide a managed care product, rather than the current indemnity model, for students.

The health care providers in your network are comprised of both hospitals and physicians. Your network hospitals consist of [REDACTED] hospitals with approximately [REDACTED] beds. All of these hospitals are either exempt under section 501(c)(3) of the Code or are instrumentalities of the State. Two of the [REDACTED] network hospitals, [REDACTED] and the [REDACTED], are owned by [REDACTED] and comprise part of the academic medical center. One of the [REDACTED] network hospitals, [REDACTED], is an academic teaching institution. The other network hospitals are primarily community based hospitals, many of which participate in teaching programs, but are not academic centers. In addition, three of the [REDACTED] network hospitals, [REDACTED], [REDACTED], and [REDACTED], participate in [REDACTED], an affiliation of [REDACTED] independent [REDACTED] hospitals that support joint educational and service arrangements.

Your network physicians consist of both primary care and specialty physicians located throughout the State. As of [REDACTED], you had [REDACTED] physician providers in your network. All of these physicians are engaged in the private practice of medicine and except for a few primary care physicians, all of these physicians have staff privileges at one or more of your network hospitals. Approximately [REDACTED] of your [REDACTED] network physicians ([REDACTED] percent) have clinical faculty appointments at an [REDACTED] hospital and approximately [REDACTED] ([REDACTED] percent) participate in an [REDACTED] faculty practice.

[REDACTED]

Your standard provider agreement with network physicians does not require a physician to have a clinical faculty appointment at an [REDACTED] hospital or to participate in an [REDACTED] faculty practice. These provider agreements are not exclusive; physicians may treat other patients and may contract with other networks. Under these agreements, physicians consent to participate in a utilization management program, the purpose of which is to facilitate the delivery of effective medical care for your network physicians in the least costly setting while still allowing for optimal treatment, recovery or rehabilitation. Under these agreements, you appoint a third party administrator to bill and collect, on behalf of your network physicians, the fees they charge to your members. These fees are based on your established schedule of fees, which your network physicians agree to accept as compensation in full for the services they provide.

LAW

Section 501(c)(4) of the Internal Revenue Code provides for the exemption from federal income taxation of civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare. Section 1.501(c)(4)-1(a)(1) of the Income Tax Regulations presents this requirement in a two-part test. An organization is described in section 501(c)(4) of the Code if (1) it is not organized or operated for profit, and (2) it is operated exclusively for the promotion of social welfare, provided no part of the organization's net earnings inures to the benefit of any private shareholder or individual. Section 1.501(c)(4)-1(a)(2)(i) of the regulations provides that an organization is operated exclusively for the promotion of social welfare if it is primarily engaged in promoting in some way the common good and general welfare of the people of the community.

Although the regulations do not specifically prohibit private benefit, such a prohibition is a logical extension of the general requirement that social welfare is for the benefit of the general community as a whole and that organizations exempt under section 501(c)(4) must be operated exclusively to promote social welfare. Certain social welfare organizations serve only the community as a whole (pure public benefit) while others benefit a particular group of people but still primarily serve community interests. However, in instances where an organization limits its benefits to members, the organization is generally considered not to be operated for social welfare purposes.

[REDACTED]

There are a number of rulings that illustrate the distinction between organizations that serve the community and those that serve only their members or some other restricted class. See, e.g., Rev. Rul. 78-69, 1978-1 C.B. 156 (providing rush hour bus service to members of the general public, where the bus service provided must be subsidized by government and the regular bus service is not adequate or commercially available, constitutes a social welfare activity); and Rev. Rul. 78-429, 1978-2 C.B. 178 (an organization was exempt under section 501(c)(4) because it met a community need by operating an airport not otherwise available to the rural communities of the area). But see Rev. Rul. 55-311, 1955-1 C.B. 72 (providing bus service for a local association of employees, the membership of which is limited to employees of a particular corporation, is not a social welfare activity).

The distinction between "pure" public benefit and private benefit is illustrated by comparing Rev. Rul. 54-394, 1954-2 C.B. 131 (an organization is not exempt under section 501(c)(4) where it provides television reception on a cooperative basis), with Rev. Rul. 62-167, 1962-2 C.B. 142 (an organization retransmitting TV signals for the benefit of the entire community qualifies as a social welfare organization.). See also Rev. Rul. 80-206, 1980-2 C.B. 185, (an organization formed to promote the legal rights of all tenants in a particular community qualifies as a social welfare organization) and Rev. Rul. 73-306, 1973-2 C.B. 179 (a similar organization, formed to protect the rights of tenants in one particular rental complex, was denied exemption).

Another example of the problem of an organization benefiting only its members is Rev. Rul. 66-148, 1966-1 C.B. 143, in which the Service held that an organization formed to establish and maintain a system for water storage and distribution was exempt under section 501(c)(4) since although it was a membership organization, its activities resulted in an increase in the level of underground water, which benefited the entire community, irrespective of membership.

Therefore, when the services furnished by an organization are beneficial to the community and available to all members of the community on an equal basis irrespective of membership, a social welfare objective will generally be found to exist. However, where an organization limits its services and benefits to its members, the organization is not ordinarily operated exclusively for the promotion of social welfare within the meaning of section 501(c)(4).

[REDACTED]

While a social welfare organization necessarily benefits private individuals in the process of benefiting the community as a whole, even when the benefits are confined to a particular group of individuals, the organization may be exempt if the general community derives a substantial benefit. Conversely, an organization that benefits a large number of people will not necessarily be organized for social welfare purposes within the meaning of section 501(c)(4) because numbers are not necessarily determinative of social welfare objectives. Social welfare is the well being of persons as a community and classification depends upon the character as public or private -- of the benefits bestowed, of the beneficiary, and of the benefactor. See Commissioner v. Lake Forest, Inc., 305 F.2d 814 (4th Cir. 1962). An organization operated primarily to serve its members by limiting sick and life benefits to members who consist of individuals of good moral character residing in a particular geographic area is not operated exclusively for the promotion of social welfare since it only provides minor and incidental benefit to the community as a whole. Rev. Rul. 75-199, 1975-1 C.B. 160.

Therefore, the issue is whether the organization's activities result in so much private benefit as to preclude it from qualifying as a social welfare organization. The test in resolving this question with respect to exemption under section 501(c)(4) is "primarily," which, as used in the regulations, means that some amount of private benefit may be permissible so long as the organization's activities remain primarily social welfare. This necessarily requires weighing the extent to which an organization's activities are social welfare activities versus those that result in a private benefit. For example, in Monterey Public Parking Corporation, 481 F.2d 175 (9th Cir. 1973), a corporation formed by merchants to alleviate a lack of parking space in a central business district was held to be exempt. The court found that even though the participating merchants received a direct private benefit, their benefit was indistinguishable from the benefits to the community as a whole. Any increased profits by the participating merchants was a benefit shared equally by all the merchants in the downtown area.

Another example of the balancing between public and private benefits is Rev. Rul. 72-102, 1972-1 C.B. 149. In this ruling, a homeowners association formed by a developer to administer and enforce covenants for preserving the architecture and appearance of a housing development and to own and maintain common green areas, streets and sidewalks for the use of development residents was held to be exempt under section 501(c)(4) of the Code even though there existed some amount of private benefit to the

[REDACTED]

developer and individual residents because these benefits were incidental to the benefit provided to the community as a whole.

A similar analysis has been applied in the case of organizations exempt under section 501(c)(3) of the Code. Although an organization's operations may be deemed to be beneficial to the public, if it also serves private interests other than "incidentally," it is not entitled to exemption under section 501(c)(3). The word "incidental" has both qualitative and quantitative connotations. To be "qualitatively incidental," any private benefit must be a necessary concomitant of the activity which benefits the public at large; in other words, the benefit to the public cannot be achieved without necessarily benefiting certain private individuals. To be "quantitatively incidental," any private benefit must be insubstantial measured in the context of the overall public benefit conferred by the activity.

Accordingly, exemption under section 501(c)(4) of the Code depends on an organization's ability to serve in some manner the general welfare of the community rather than providing benefits primarily to its members or to other interested parties.

The activities of an exempt organization must also be distinguishable from similar activities conducted by ordinary commercial enterprises. A number of revenue rulings and court cases have applied this principle to organizations seeking exemption under section 501(c)(3) of the Code. These revenue rulings and cases are discussed below. The same principle is applicable to organizations seeking exemption under section 501(c)(4).

Rev. Rul. 54-305, 1954-2 C.B. 127, describes an organization whose primary purpose is the operation and maintenance of a purchasing agency for the benefit of its otherwise unrelated members who are exempt as charitable organizations. The ruling held that the organization did not qualify under section 101(6) of the Code (the predecessor to section 501(c)(3)) because its activities consisted primarily of the purchase of supplies and the performance of other related services. The ruling stated that such activities in themselves cannot be termed charitable, but are ordinary business activities.

Rev. Rul. 69-528, 1969-2 C.B. 127, describes an organization formed to provide investment services on a fee basis only to organizations exempt under section 501(c)(3) of the Code. The organization invested funds received from participating tax-exempt organizations. The service organization was free from the

[REDACTED]

control of the participating organizations and had absolute and uncontrolled discretion over investment policies. The ruling held that the service organization did not qualify under section 501(c)(3) of the Code and stated that providing investment services on a regular basis for a fee is a trade or business ordinarily carried on for profit.

Rev. Rul. 72-369, 1972-3 C.B. 245, describes an organization formed to provide management and consulting services at cost to unrelated exempt organizations. This ruling stated:

An organization is not exempt merely because its operations are not conducted for the purposes of producing a profit. . . . [P]roviding managerial and consulting services on a regular basis for a fee is a trade or business ordinarily carried on for profit.

In B.S.W. Group, Inc. v. Commissioner, 70 T.C. 352 (1978), the organization entered into consultant-retainer relationships with five or six limited resource groups involved in the fields of health, housing, vocational skills and cooperative management. The organization's financing did not resemble that of the typical section 501(c)(3) organization. It had neither solicited, nor received, any voluntary contributions from the public. The court concluded that because its sole activity consisted of offering consulting services for a fee, set at or close to cost, to nonprofit, limited resource organizations, it did not qualify for exemption under section 501(c)(3) of the Code.

In Christian Stewardship Assistance, Inc., 70 T.C. 1037 (1978), a nonprofit corporation that assisted charitable organizations in their fund raising activities by providing financial planning advice on charitable giving and tax planning to wealthy individuals was held not to qualify under section 501(c)(3) of the Code because its tax planning services were a substantial nonexempt activity that provided a private benefit to its contributing clients.

An organization that merely promotes health, without more, is not entitled to recognition of exemption under section 501(c)(3). For example, while selling prescription pharmaceuticals promotes health, pharmacies cannot qualify for recognition of exemption under section 501(c)(3) on that basis alone. In Federation Pharmacy Services, Inc. v. Commissioner, 72 T.C. 687 (1979), aff'd, 625 F.2d 804 (8th Cir. 1980), the Tax Court stated:

[REDACTED]

Virtually everything we buy has an effect, directly or indirectly, on our health. We do not believe that the law requires that any organization whose purpose is to benefit health, however, remotely, is automatically entitled, without more, to the desired exemption. 72 T.C. at 692.

#### RATIONALE

1. Section 1.501(c)(4)-1(a)(2)(i) of the regulations provides that an organization is operated exclusively for the promotion of social welfare if it is primarily engaged in promoting in some way the common good and general welfare of the people of the community. While a social welfare organization necessarily benefits private individuals in the process of benefiting the community as a whole, the organization may be exempt if the general community derives a substantial benefit. Conversely, an organization that benefits a large number of people will not necessarily be organized for social welfare purposes because numbers are not necessarily determinative of social welfare objectives. Therefore, the issue is whether your organization's activities result in so much private benefit as to preclude it from qualifying as a social welfare organization. The test in resolving this question with respect to exemption under section 501(c)(4) is "primarily," which, as used in the regulations, means that some amount of private benefit may be permissible so long as your organization's activities remain primarily social welfare. This necessarily requires weighing the extent to which your organization's activities are social welfare activities versus those that result in a private benefit. By offering access to your health care provider network to employees of small employers, a group that is generally considered to be medically underserved, you are providing a benefit to the community.

Your network is comprised of tax-exempt hospitals and private practice physicians. Your network physicians, by participating in your network, are obtaining additional patients and revenues and are increasing their market share. These physicians benefit by attracting a larger volume of patients while preserving the concept of fee-for-service medicine and avoiding the assumption of financial risk for overutilization. In addition, only about [REDACTED] percent of your network physicians have clinical faculty appointments at an [REDACTED] hospital and only about [REDACTED] percent participate in an [REDACTED] faculty practice arrangement. Your network is also comprised of tax-exempt hospitals, only [REDACTED] of which are academic teaching centers affiliated with [REDACTED].



[REDACTED]

These [REDACTED] hospitals have [REDACTED] beds or only [REDACTED] percent of the total available beds in your hospital network. Therefore, to the extent that your network physicians refer your contract holders' employees to the [REDACTED] teaching hospitals in your network, this contributes to the ability of these hospitals and the [REDACTED] faculty to educate [REDACTED] medical students, thereby providing a benefit to the community. However, since only a small portion of your network physicians and network hospitals are affiliated with [REDACTED], this does not assure a substantial flow of patients to [REDACTED] teaching hospitals to enhance the education of [REDACTED] medical students.

Therefore, your activities primarily benefit the private and commercial interests of your private practice physicians, rather than the community as a whole.

2. While the promotion of health is considered a charitable purpose within the meaning of section 501(c)(3) of the Code, not all activities that promote health are considered charitable such that an organization engaging in such activities is entitled to exemption under section 501(c)(3). See Federation Pharmacy Services, Inc., supra. Similarly, not all activities that promote health achieve the tax-exempt purpose under section 501(c)(4) of promoting the common good and general welfare of the people of the community and bringing about civic betterments and social improvements. See section 1.504(c)(4)-1(a)(2)(i) of the regulations. Although one result of your providing the various services described above to your contract holders is improving access to, and delivery of, health care services to persons who are generally considered to be medically underserved, that result is incidental to your principal purpose of providing managed care services, which are purely commercial activities, to your subscribing organizations. Providing these services for a fee is a commercial activity that does not directly promote health, even if the fee is below market value. See e.g., Rev. Rul. 72-369, supra. There is no broad community benefit that results from such activity. Providing these services does not directly promote the common good and general welfare of the community or bring about civic betterments and social improvements but rather represents an ordinary commercial activity. See e.g., Rev. Rul. 54-305, supra; Rev. Rul. 69-528, supra; B.S.W. Group, Inc., supra; Christian Stewardship Assistance, Inc., supra; and Living Faith, Inc., supra.

Therefore, by providing greater access to health care providers and improved health care services to the employees of your contract holders, and by providing [REDACTED] with network management services, you are providing commercial services to [REDACTED]

[REDACTED]

and to your other contract holders. These services primarily benefit your network physicians and only incidentally benefit the community as a whole. This is true even though your activities may to some degree also assist [REDACTED] in furthering the education of its medical students.

#### CONCLUSION

For the reasons stated above, you do not qualify for exemption as an organization described in section 501(c)(4) of the Code and you must file federal income tax returns.

You have the right to protest this ruling if you believe it is incorrect. To protest, you should submit a statement of your views, with a full explanation of your reasoning. This statement, signed by one of your officers, must be submitted within 30 days from the date of this letter. You also have a right to a conference in this office after your statement is submitted. You must request the conference, if you want one, when you file your protest statement. If you are to be represented by someone who is not one of your officers, that person will need to file a proper power of attorney and otherwise qualify under our Conference and Practice Requirements.

If we do not hear from you within 30 days, this ruling will become final and copies will be forwarded to your key district office. Thereafter, any questions about your federal income tax status should be addressed to that office.

When sending additional letters to us with respect to this case, you will expedite their receipt by using the following address:

Internal Revenue Service  
[REDACTED]  
CP:E:EO:T:1, Room 6514  
1111 Constitution Ave, N.W.  
Washington, D.C. 20224

For your convenience, our FAX number is [REDACTED].

If you have any questions, please contact the person whose name and telephone number are shown in the heading of this letter.

[REDACTED]

In accordance with the Power of Attorney currently on file with the Internal Revenue Service, we are sending a copy of this letter to your authorized representative.

Sincerely,

(sig)

[REDACTED]  
Chief, Exempt Organizations  
Technical Branch 1